Taxation -- Income -- Family Partnerships

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contrary intent is shown in the will, a power of appointment will be
deemed exercised by a general bequest or devise or by a general re-
siduary clause.

The Cardeza decision still seems to be limited by Estate of Kerr v.
Commissioners in which the Tax Court held the entire amount of the
interests taxable in the donee's estate even though the new interests,
remainders, were merely a smaller part of the default interests, estates
in fee. However, the court distinguished its decision in the Cardeza
case on the ground that there were in that case no new interests created
under the power, the appointee taking exactly what he had before the
attempted exercise of the power.

ROBERT L. HINES.

Taxation—Income—Family Partnerships

Great difficulty has been encountered in determining the status of
family partnerships as a means of effecting tax savings through a divi-
sion of income among the family members. Culbertson v. Commis-
sioner, although more favorable to the taxpayer than prior decisions
in the Tax Court, has admittedly produced greater subjectivity and con-
sequently increased uncertainty in an area already extensively litigated.
Although provision under the Revenue Act of 1948 for joint returns
of husband and wife virtually renders consideration of this type of
partnership unnecessary, the problem is still much alive in the formation
of parent-child arrangements.

An understanding of the well recognized principles governing tax
liability in these family arrangements is essential as a background to
Culbertson. Lucas v. Earl ruled that the tax burden may not be shifted
by an assignment of future income from services rendered by the assign-
or; income is taxable to the tree which actually bore the fruit. As a
corollary, income from property may be taxable to the donor if he re-

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17 9 T. C. 359 (1947) (the fee given in default was decreased to a remainder
interest by partial appointment to a stranger, and although there was a renuncia-
tion by the appointee, he still took that particular estate under the power).

18 Johnston v. Knight, 117 N. C. 122, 23 S. E. 92 (1895) (the intention of the
donee to execute the power, however manifested, will make the execution valid
and effective, and unless the contrary is shown by the testator's will a general
residuary clause will operate as an execution of the power); Taylor v. Eatman,
92 N. C. 601 (1885) ("It is not necessary to refer to the power if the act shows
that the donee had in view the subject of the power at the time."); see Cone v.
Commissioner, 31 B. T. A. 515, 518 (1934) (the Board says the intent to exercise
the power must come from reference to the power, direct reference to the subject
matter, or it may appear from the facts that the instrument would be inoperative
without the exercise of the power).

19 Sup. Ct. 1210 (1949), reversing 168 F. 2d 979 (5th Cir. 1948).

20 281 U. S. 111 (1930) (future salary and attorney's fees).
tained the substance of full enjoyment of all rights and benefits even though he assigned the already accrued right to receive the income—Helvering v. Horst. Blair v. Commissioner, however, drew this distinction: when there is a recognized valid transfer of income producing property, the income from that property must per force be taxable to the transferee. Vigilant to distinguish substance and effect from form and method, Helvering v. Clifford refused to recognize a transfer for tax purposes of the beneficial interest where so many strings were retained by the donor-settlor over the trust property that the actual dominion and control of the corpus and the ultimate beneficial use of the income had not shifted. Thus Clifford asks: who controls the production and allocation of the income?

The Earl-Horst, Clifford doctrines and the Blair rule have been viewed as two sometimes conflicting lines of judicial reasoning. It therefore becomes important to determine whether capital or services is the predominant factor in the production of the firm income in order to appreciate the applicability of these principles and the relative significance of the various tests of partnership validity for tax purposes.

The celebrated decisions of Commissioner v. Tower and Lusthaus v. Commissioner served to decelerate greatly recognition of family partnerships by the Tax Court under the Internal Revenue Code. In both cases the wife's partnership interest was denied where a prior gift by the husband was the basis of her capital contribution. The transactions were viewed as superficial arrangements which did not result in any actual change in the economic relationships in the business or in the family. Practically, more important than what Tower and Lusthaus said was what the Tax Court, in the ensuing months, thought they said. The tests of original capital contribution, vital services, and, to a lesser extent, control and management, which had been stated as factors evincive of a business purpose, were interpreted to be conclusive. This understandable adherence to stock tests susceptible of some degree of certainty and objectivity proved fatal to countless partnerships.

3 311 U.S. 112 (1940) (negotiable coupons for interest detached from bonds); cf. Helvering v. Eubank, 311 U.S. 122 (1940) (insurance renewal commissions). 4 300 U.S. 5 (1937) (father's gift to his children of part of his interest in a trust of which he was beneficiary). 5 309 U.S. 331 (1940) (short term trust, reversionary rights). 6 327 U.S. 280 (1946) (conditional gift of stock in predecessor corporation). 7 327 U.S. 293 (1946) (gift from husband and notes payable out of her share of profits). 8 Applicable provisions are INT. REV. CODE §§11, 22(a), 181, 182, 3797. 9 Circuit courts have been more generous to the taxpayer than the Tax Court. This fact is even more important since the rule of Dobson v. Comm'r., 320 U.S. 489 (1943) has been repudiated by amendment to §1141(a) of INT. REV. CODE. Decisions of the Tax Court are now reviewable "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." See Note, 1 STAN. L. REV. 305 (1949).
In Culbertson, therefore, the Court was confronted with the task of correcting misdirected emphasis. At the insistence of a partner bowing out of a cattle firm because of ill health, the four sons of the other partner, the taxpayer, were given a one-half interest in order to preserve intact the brood herd. The sale of this interest to the sons was accomplished by a note which was largely paid by (1) a gift from the taxpayer, and (2) a loan procured by the newly formed Culbertson & Sons partnership. Since the sons were in the Army and in college during the tax years, no substantial services were rendered. The Tax Court taxed the entire income to the father; the Fifth Circuit reversed, holding it enough that the sons intended to contribute their efforts to the business in the future. The Supreme Court rejected both interpretations and remanded the cause to the Tax Court. Tax validity was made to turn on an issue of whether, in consideration of all the facts, "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." True, absence of evidence of the old determinative factors has the effect of placing a heavy burden in proving bona fide intent, but presence or absence of any or all of these factors is no longer controlling. This much is made clear: original capital is not essential; intent may be predicated upon investment of an intra-family gift. It is uncertain how far reaching the effects will be. Significant indeed is the recent statement of a distinguished circuit judge: "The Commissioner asserts that Culbertson represents an affirmation of the rationale of Tower and Lusthaus. We doubt the validity of this contention."

What are the basic criteria, considered separately, which go to prove or defeat a bona fide intent to form a "business purpose" partnership?

Capital contribution. Origination of the capital with the incoming family member, while no longer a requirement, is of great evidentiary value in proving that there is in fact a valid contribution rather than a sham paper reallocation. Capital from the personal estate of the ostensible partner is the most readily acceptable. If the source is a prior

10 Culbertson v. Comm'r., 69 Sup. Ct. 1210, 1216 (1949).
11 A reading of a portion of the opinion without reference to the decision in its entirety may well lead to the conclusion that either contribution of capital or rendition of services within the tax year is still essential; to wit: "if it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax years in question ... it can hardly be contended that they are in any way responsible for the production of income during those years." (p. 1215). Clearly, this is dictum which a literal minded Tax Court could seize upon to justify a continuation of their previous line of reasoning.
13 Canfield v. Comm'r., 168 F. 2d 907 (6th Cir. 1948) (inheritance); Weizer v. Comm'r., 165 F. 2d 772 (6th Cir. 1948) (insurance policy); Florence R. Miller, 5 CCH 1949 Fed. Tax Rep. §7184(M) (T. C. 1949) (gift in trust to purchase partnership interest).
gift of money from the taxpayer, recognition seems most often to de-
pend on whether it is anticipatory to the formation of the partnership.14 It is enough that the contribution to the business was made some years prior to the tax year.15 Contributions in the form of notes payable out of the profits of the partnership or by a gift from the taxpayer have not generally been held sufficient.16 Nor have contributions of proceeds from a gift of stock in a predecessor corporation donated in anticipation of the creation of the partnership satisfied the test in most cases.17

Vital services.18 The following considerations are germane to this test: (1) relative importance in the scheme of the business;19 (2) competence of the family member by way of special training and practical experience;20 (3) reliance placed on the judgment and position of the alleged partner;21 (4) status as more than a mere employee who receives wages periodically.

In a partnership which is chiefly one of personal service it is more essential that the family member stand in the shoes of any other partner who holds an interest by his service. At times the Tax Court has been prone, unrealistically, it is believed, to label services of a family member as "wifely assistance" or "voluntary"—a mere filial or marital duty.22 Thus, it is incumbent on the taxpayer’s attorney to negative this impli-

15 Graber v. Comm’r., 171 F. 2d 32 (10th Cir. 1949).
16 Lusthaus v. Comm’r., 327 U.S. 293 (1946) (profits); Boyd v. Comm’r., 171 F. 2d 546 (6th Cir. 1949) (gift); Hougland v. Comm’r., 166 F. 2d 815 (6th Cir.), cert. denied, 334 U.S. 846 (1948) (profits). But where basis is a loan secured by the partnership, Culbertson will direct a different result.
17 Comm’r. v. Tower, 327 U.S. 280 (1946); Scherf v. Comm’r, 161 F. 2d 495 (5th Cir. 1947); Maudlin v. Comm’r, 155 F. 2d 666 (4th Cir. 1946). Test satisfied where gift of stock was not anticipatory in Lawton v. Commissioner, 164 F. 2d 380 (6th Cir. 1947).
18 Notice use of phrase, “valuable services,” Graber v. Comm’r., 171 F. 2d 32 (10th Cir. 1949); “substantial services,” Wilson v. Comm’r., 161 F. 2d 651 (7th Cir. 1949).
Office work in a supervisory capacity is increasingly being given cognizance. Ron W. Wood, 5 CCH 1949 Fed. Tax Rep. §7413(M) (T. C. 1949) (maintenance of business records, custody of funds, hiring of personnel); David L. Jennings, 10 T. C. 505 (1948).
Of vital importance: William Grace, 10 T. C. 1 (1948) (employing and discharging personnel, sales promotion, closing sales contracts).
20 Son received college training for the job: Culbertson v. Comm’r., 69 Sup. Ct. 1210 (1949); Lawton v. Comm’r., 164 F. 2d 380 (6th Cir. 1947). Commerce school partnership valid where wife better qualified than taxpayer husband because of training and experience: Allen v. Knott, 166 F. 2d 798 (5th Cir. 1948).
21 Woosley v. Comm’r., 168 F. 2d 330 (6th Cir. 1948); S. B. Forsythe, 10 T. C. 417 (1948) (taxpayer illiterate).
cation with clarity. It is suggested that an inference of “filial aid” is less apparent. Services during the tax year are most acceptable; future services are ineffective, asserts Culbertson—although in view of the Culbertson standard of bona fide intent this is open to some doubt. There are indications that services prior to tax years are influential.

Receipt and use of the profits. A separate bookkeeping entry and segregation of funds, as by creation of a separate bank account, are persuasive indicia. The partner must have unhampered use of his earnings. Status is doubtful where proceeds though credited to the family member must remain in the business, or cannot be withdrawn without the taxpayer’s consent, or where the use of the income is controlled by the taxpayer. Some cases state that if the family member, especially the wife, uses the income to purchase family necessaries, the income is not truly that of the family member—a position not exempt from attack. The rule purported to be followed is that there must be a substantial change in the economic relationship among the family members and in the dominion over the business.

Management and control. What voice does the ostensible partner have in policy formation and the direction of business affairs (as distinguished from services)? Where there has been an outright gift of the interest in the firm, the absence of any participation in the management may serve to defeat division of income. The right to repurchase the interest either at original value or value at the time of repurchase is indicative of lack of control by the alleged partner.

Form of the agreement. The form of the agreement is not so important as the fact of the agreement. It cannot be an afterthought. Oral agreements have been held effective, but the existence of a formal written partnership agreement is of strong evidentiary value to mani-

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- **Canfield v. Comm’r.,** 168 F. 2d 907 (6th Cir. 1948); Appel v. Smith, 161 F. 2d 121 (7th Cir. 1947).
- **Econemos v. Comm’r.,** 167 F. 2d 165 (4th Cir. 1948).
- **E.g.,** Jerry Malatico, 12 T. C. 146 (1949).
- **Fletcher v. Comm’r.,** 164 F. 2d 182 (2d Cir. 1947).
- **Davis v. United States,** 5 CCH 1949 Fed. Tax Rep. §9349 (6th Cir. 1949) (agreement: “absolute, unquestioned right at any time he [taxpayer] may desire, to purchase the one-tenth interest”).
fest an intent to form a partnership. The written agreement, however, may be unfortunate if it includes statements which the Tax Court can seize upon as indicative of a “mere paper reallocation.” Also, the court may conceivably look upon the technical intricacies of the articles of agreement as form without substance skillfully drawn to give appearance of reality when the draftsman’s purpose is tax avoidance.

Business motive may be further manifested by: (1) proper notification of the existence of the partnership to or recognition by parties doing business with the firm or inclusion of the family member in the trade name, tested by the query: was it known to the world as a partnership?; (2) improvement of credit standing by inclusion of family member’s personal liability—absent original contribution of capital; (3) interest in perpetuating the business in the family by training the partner someday to assume full control; (4) interest in securing fuller cooperation in the present operation of the business by giving family member responsibility of partnership standing; (5) request by family member to be made a partner, or demand by other partner or business associate outside of the family; (6) reasonable proportion between share of earnings and the income producing value of the contribution made to the firm; and (7) consistency in treatment of all phases of the purported partnership in regard to the family arrangement.

What is the effect of a tax avoidance motive? The answer is one of uncertainty since the language used by the courts often seems inconsistent with the results reached. Clearly, evidence of a tax avoidance motive has often been the elusive straw that broke the partnership’s back. This result may be rationalized by saying that it operates in a negative fashion, militating against bona fide intent to do business in the partnership form; though it may be that freedom from the tax avoidance motive should baldly be listed among the requirements of tax validity. Courts still pay lip service to the principle that the taxpayer may reduce his tax burden by any legal means, but the Tax Court seldom foregoes an opportunity to “pierce the shroud” and lay

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33 Hartz v. Comm’r., 170 F. 2d 313 (8th Cir. 1948).
34 Culbertson v. Comm’r., 69 Sup. Ct. 1210 (1949).
35 A unique development is the reallocation by the Tax Court, in disregard of the express provisions of the articles of partnership, of the income according to the relative income producing value of the partner’s contribution. Robinson, The Allocation Theory in Family Partnership Cases, 25 Taxes 963 (1947). But in view of the rejection of this judicial contract-writing by the circuit courts in Canfield v. Comm’r., 168 F. 2d 907 (6th Cir. 1948), and Woosley v. Comm’r., 168 F. 2d 330 (6th Cir. 1948), the process of reallocation may have been abated. In addition, the court has recognized certain participants in the agreement and not others, selecting those around whom the halo of bona fide intent glows most brightly. W. F. Harmon, 5 CCH 1949 Fed. Tax Rep. §7596 (T. C. 1949); R. C. Hitchcock, 12 T. C. 22 (1949).
bare an attempt to escape the tax burden. It is submitted that the distinction should be more clearly delineated between tax avoidance as a primary or sole aim, which may negate business purpose, and tax avoidance as a concomitant or secondary result, which is not relevant to Tax Court findings.

It has often been stated that validity of the partnership under state law has no bearing on tax recognition. The effect, however, of validity under commercial rules on tax determination could quite conceivably be changing. It is arguable that, since under a partnership recognized by the local law, the separate property of the family member in the event of insolvency is liable for the satisfaction of partnership debts; and since the member is entitled to his portion of the assets in event of dissolution, there are present the necessary elements of reality, business purpose, and change in domination which are demanded. Mr. Justice Frankfurter in Culbertson asserts that Tower "did not purport to announce a special concept of 'partnership' for tax purposes differing from the concept that rules in ordinary commercial law cases."

Treatment of the problem by the courts since Culbertson is significant. Although many questions are left unanswered, several clear indications are discernible.

1. By and large the courts have accepted the change in emphasis, required by the Supreme Court, from exclusive determinative tests to a consideration of all factors revealing intent.
2. If capital contribution is relied upon, it need not be original with the family member; effect is given though the source is a prior irrevocable gift from the taxpayer.
3. Although the result does not necessarily follow, in practical effect a partnership which would have been valid before Culbertson will likely be valid now.
4. Absent other factors, an outright gift of an interest is still ineffective.
5. Evidence of tax avoidance motive may still be fatal.46
6. Generally the courts have caught the spirit of Culbertson remarkably well. Although numerical weight settles nothing, it may be noted that the majority of decisions since Culbertson have been favorable to the taxpayer; decidedly the opposite was true previously.

Two cases which seem to prescribe typically the limits under Culbertson deserve special notice. The court in Morrison v. Commissioner47 denied validity where, though the formalities of agreement were indulged in, the taxpayer retained domination over the business, providing no separation of earnings nor power of ostensible partners to draw checks on the account. In Ginsberg v. Arnold48 the interest of the son was a direct gift; the father exercised control over the writing of checks; the son was in the Army during the tax years. Yet on rehearing the circuit court found an intent to create a partnership for the benefit of the business.

In order to encourage this socially desirable method of perpetuating the family business; in order to reduce the inequality in the effect given intra-family transfers within corporations and in partnerships;49 in order to recognize the very real consequences of a genuine commercial partnership, perhaps parent-child partnership will be viewed more favorably by the courts under the impetus of the Culbertson case.50

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Torts—Unborn Child—Right of Action for Prenatal Injury

A search through the North Carolina Digest, Reports, and Annotated General Statutes has disclosed no North Carolina case in which an action has been brought by or on behalf of a child for prenatal injuries. A probable reason for this situation is that, by the decided preponderance of case authority, no right of action has been recognized for

49 There is evidence, however, of the beginnings of a movement to reduce the transfer rights within a corporation to the partnership level. See Alexandre, The Corporate Counterpart of the Family Partnership, 2 Tax L. Rev. 493 (1947).
50 Congressional action has been suggested to tax the income of parents and minor children as a unit or to deal with the family partnership problem as a whole. See Wales, The 1949 Relevance of the Revenue Bill of 1948, 62 Harv. L. Rev. 957, 972-74 (1949).